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Venezuela: Implications of the Economic Plunge

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An Intelligence Assessment

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ALA 83-10039
March 1983

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Notice

On 24 March Caracas suspended all debt principal payments until 1 July while it negotiates a refinancing package. The move, which arises from the conditions described in this paper, does not alter our judgments. [redacted]

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Venezuela: Implications of the Economic Plunge [redacted]

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An Intelligence Assessment

This assessment was prepared by [redacted] 25X1
[redacted] of the Office of African and 25X1
Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, South America Division, ALA, [redacted] 25X1

This assessment was coordinated with the Directorate of Operations and the National Intelligence Council. [redacted] 25X1

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March 1983

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Venezuela: Implications of the Economic Plunge [redacted]

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Key Judgments

Information available as of 18 March 1983 was used in this report.

Venezuela's current economic straits—financial difficulties and a fourth year of stagnation—reflect its extreme susceptibility to disturbances in world oil and financial markets. This vulnerability has been compounded by past overspending and the failure to diversify the economy and better manage the foreign debt. President Herrera's inconsistent policies have added to these problems since 1979, making his Social Christian administration one of the most unpopular in two decades.

With elections this December, Herrera's current austerity program will be at risk from strong party pressures for pork barrel spending. We believe Herrera is committed to, and has little choice but to preserve, most of his measures. However, his program offers no prospect of reactivating the economy before he leaves office.

Venezuela's economic performance will probably be worse than anticipated by the government. The reduction in Venezuelan oil prices and the impending sense of financial crisis over managing the foreign debt will force tougher domestic adjustments this year. To forestall serious payment problems, Caracas has already announced exchange controls to contain capital flight. Even so, there is a better-than-even chance that Venezuela will still encounter a foreign exchange crisis by mid-1983, leaving Caracas little choice but to devalue and declare a debt moratorium.

These worsening problems almost assure a presidential victory in December by the opposition Democratic Action candidate, Jaime Lusinchi. But whichever of the two major parties wins, we expect very similar government economic strategies—heavily emphasizing austerity—as well as similar results for the next four to five years. We judge that Venezuela faces dim economic prospects for the period.

The problems in the economy will introduce unaccustomed political stresses over the next few years as well. Our analysis of Venezuela's democratic system, the new forces at play, and the latest opinion samplings lead us to judge the chances of regime-threatening instability over the near term to be slight. In the unlikely event that a severe and prolonged price war among oil producers held the average OPEC per barrel price below $20, however, and Venezuela resisted difficult adjustments, an economic crisis and widespread civil disorders would result. This would probably lead the conservative armed forces to seize power. This paper presents a number of indicators that would warn of such changes.

ALA 83-10039
March 1983

Venezuela's outlook—little growth and heavier political sledding for any administration—carries several implications for the United States:

- Some greater measure of trade protectionism is likely, although Caracas will become increasingly receptive to foreign equity participation in industrial and petroleum projects.

- Caracas will remain ideologically committed to democracy in Central America and the Caribbean, but domestic constraints will more narrowly limit its involvement in regional affairs. Specifically, the joint Venezuelan-Mexican petroleum financing facility is in danger of being scrapped, and regional aid programs will be sharply curtailed.

- Because of budget constraints, both the new administration and the military will be less inclined than previously to press border disputes, including the controversy with Guyana.

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Contents

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Venezuela: Implications of the Economic Plunge [redacted]

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Introduction

In addition to depressed oil revenues, the incumbent Venezuelan administration must contend this year with managing an enormous debt and resisting pressures for spending that will be spawned by the 1983 presidential race. Further disruptions in the world oil and capital markets would only exacerbate these problems. These events augur major challenges for the political leaders who will assume power next year. They will have to forge a political consensus to adjust national development strategies, reorient a populace that expects a rising standard of living, and deal with serious foreign financing problems. [redacted]

This paper examines the principal political and economic constraints influencing the choice and implementation of adjustment strategies; it reviews probable policy choices and their domestic impact; and it assesses the implications of the economic slowdown for Venezuela's relations with the United States. [redacted]

Allure of Oil Wealth

Since the first major oil discovery in 1914, petroleum has dominated Venezuela's national development. Oil sustained high economic growth rates and gave Venezuela the second-highest per capita income in the region. Two successive oil booms in the mid-1970s added to expectations—reflected in statements of political leaders—that oil revenues would continue to increase rapidly, allowing Venezuela to develop a diversified industrial base and to become a significant regional power. [redacted]

Following the first oil boom (1973-74), President Carlos Andres Perez began large-scale government investments in heavy industries and chemicals to diversify the economy. At the same time, he increased social welfare expenditures while instituting large consumer subsidies for food and petroleum products. New spending and investment projects boosted real GDP growth sharply to an average annual rate of 6 percent for 1974-78. Both major political parties nurtured the public's belief that massive oil monies would continue to fuel national prosperity. [redacted]

These policies, however, laid the foundations for problems inherited by Herrera. The newly created state corporations registered huge losses. To repress mounting inflation, the government adopted tight price controls and producer subsidies. Venezuelan entities turned to eager international lenders—in the absence of controls on short-term borrowings—to cover their expanding deficits. On the basis of various unclassified sources, we estimate that total external debt increased from only \$2.5 billion in 1973 to \$20.8 billion in 1978. Meanwhile, declining productivity, rising real wages, and controls on prices and interest rates were seriously undermining private-sector 25X1
investment incentives. [redacted] 25X1

The Herrera Retrenchment

Inconsistent Policies. When President Luis Herrera Campins took office in 1979, he curbed some of the free-spending programs and tightened fiscal and monetary policies to stabilize finances, but at the expense 25X1
of further dampening private investment. A windfall rise in petroleum income enabled Herrera to trim the fiscal deficit to \$135 million by 1981, even though the government failed to reduce subsidies or discipline the inefficient state corporations. [redacted] 25X1

Caracas was less successful in implementing other reforms to improve efficiency. The dismantling of price controls was slowed as the release of strong inflationary pressures sparked challenges from the politically powerful labor sector. Interest rates were kept artificially low until September 1981 to induce 25X1
outflows of excess currency. In addition, the government began to limit external borrowings, even as it took a full two years to inventory and to program the restructuring of that debt. [redacted] 25X1

Various opinion polls showed that, as stagflation persisted, the Venezuelan public laid the blame for economic problems on President Herrera. According to press and US Embassy reporting, the government's

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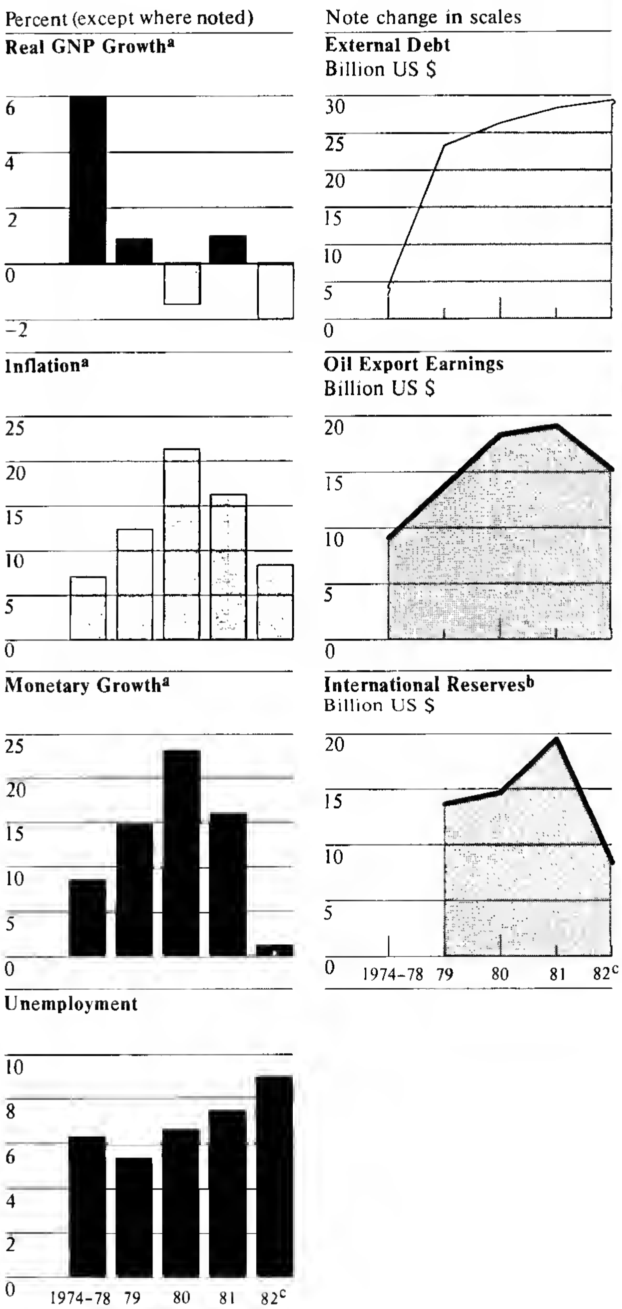
Venezuela: Economic Indicators



[a] Average annual.
[b] Excludes reevaluation of gold holdings.
[c] Estimated.

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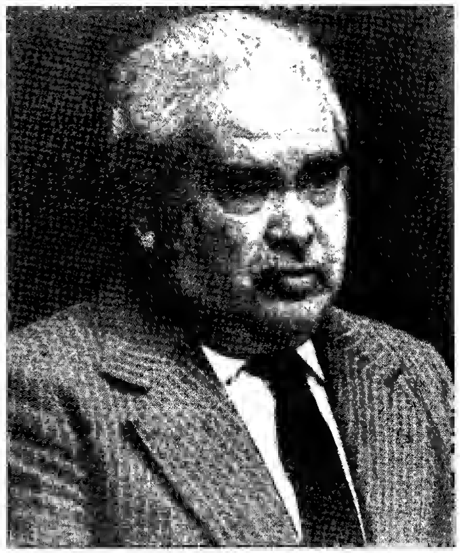

President Luis Herrera Campins UN Chronicle

halting policies seriously undermined business confidence and new private-investment spending. The slowdown in public investment preempted any stimulus from that sector. As a result, GNP growth has averaged under 1 percent per year since 1978. Annual inflation has averaged 17 percent over the same period, while unemployment edged up to 7.5 percent by 1981. 25X1

On the brighter side, the influx of petrodollars helped Venezuela greatly strengthen its current account position and to build up large reserves. By the end of 1981, the central government and its agencies reported reserves of over $11 billion, while the state-owned oil company (PDVSA) held an additional $8.5 billion, combining to provide 19 months of import coverage. Under these circumstances, Venezuela was able—even though it continued to drag its feet on debt restructuring—to roll over maturing obligations at favorable rates. 25X1

1982 Setbacks in Oil Earnings. According to US Embassy and other reporting, the Herrera administration hoped to use oil revenues to restore stable, noninflationary growth in 1982, before the presidential election campaign focused public attention on the

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1982 Economic Performance

Venezuela's Central Bank claims GNP growth of 0.4 percent in 1982, but more realistic US Embassy estimates show an actual contraction of around 2 percent. Declines were registered in the petroleum and mining sectors, and the construction and capital goods industries were hit hard by the slowdown in government investment expenditures and high domestic interest rates. Nonoil sectors grew by an anemic 1.1 percent, but industrial recovery was lackluster in the face of tight money policy and a continued unfavorable investment climate.

This dropoff in economic activity and the tight monetary policies led to a reduction in the rate of inflation from 16.2 percent in 1981 to just over 8 percent last year. The real money supply grew only 1.2 percent compared to 16.0 percent in 1981, as capital flight raged and infusions of oil revenues fell off sharply. Despite the increase in domestic gasoline prices, the government limited upward pressure on price levels by lengthening its approvals for private requests for price increases.

Venezuela's current account fell into deficit by \$2.2 billion last year, a \$6.1 billion swing from 1981's \$3.9 billion surplus. That deterioration reflected a 20-percent decline in total exports, a 10.7-percent increase in imports, and a 17.1-percent widening of the deficit on net services and transfers. Unwilling—and probably unable—to raise new loans, Caracas was forced to draw down reserves to cover the deficit. Foreign exchange holdings were further diminished by loan payoffs of over \$500 million and the speculative movement abroad of some \$5 billion—according to Central Bank estimates—during the year. As a result, Venezuela's net international reserves dropped from \$19.5 billion at the end of 1981 to just under \$8.5 billion in late December 1982, excluding a \$3 billion boost from the gold revaluation

economic downturn. Unfortunately for Herrera, declining crude oil prices and reduced Venezuelan exports—the result of weak demand in a conservation-minded and recession-choked developed world—caused oil export earnings to drop 20 percent below the previous year. Forced to cut \$4 billion from budget-revenue projections, Herrera renewed public-sector efficiency measures, scaled back plans to boost public investments, and sharply increased gasoline prices, which nonetheless remain among the lowest in the world. 25X1

Political expediency, however, diluted Herrera's efforts somewhat. The leading opposition party, Democratic Action (AD), and even the presidential nominee of the governing Social Christian Party (COPEI) sharply criticized the failure to anticipate the downward slide in oil earnings. Opinion polls reflected the public's rising frustration with the Herrera government, with more than 60 percent of the respondents rating the administration's performance as "bad" or "very bad." Herrera reacted by resisting further cost-cutting measures—particularly for politically sacrosanct social programs—even as government statistics revealed that efficiency measures were not achieving desired savings. 25X1 25X1

To sustain expenditures, Caracas instead opted to boost oil revenues. After abiding by the OPEC-imposed production limit of 1.5 million barrels per day (mb/d) for one quarter, Venezuela hiked production to 2.3 mb/d by the end of the year. While the move provoked widespread criticism from other OPEC members and from Venezuela's strong domestic supporters of OPEC, in the US Embassy's opinion Herrera feared more damaging repercussions from depressed oil export earnings, particularly in view of the coming election campaign. 25X1 25X1

New Difficulties in Borrowing and Capital Flight. New problems in international borrowing and accelerating capital flight seriously hampered Herrera's ability to use oil revenues as an economic stimulant. By March 1982, press reports indicated that bankers were insisting on sharply higher rates for new loans, leading the government to suspend restructuring operations in hopes that oil prices would rebound to ease bankers' anxieties. This strategy backfired in the wake of growing South American debt repayment 25X1

Table 1 *Billion US $*
Venezuela's Current Account Balance

	1979	1980	1981	1982 [a]	1983 [a]
Merchandise exports, f.o.b.	14.4	19.0	20.1	16.0	14.1
Oil	13.7	18.3	19.1	15.2	13.3
Other	0.7	0.7	1.0	0.5	0.8
Merchandise imports, f.o.b.	10.0	10.7	12.1	13.4	11.3
Trade balance	4.4	8.3	8.0	2.6	2.8
Net services and transfers	−4.0	−4.7	−4.1	−4.8	−5.0
Current account balance	0.4	3.6	3.9	−2.2	−2.2

[a] Estimated.

[redacted]

problems, and in September Caracas was forced to pay off two $300 million loans for cash-strapped government agencies. [redacted] 25X1

[redacted] this gave Caracas its first indications that it would encounter serious difficulty in refinancing its debt, and that it urgently needed to improve its debt structure—the worst in Latin America. The government thus approved a three-year plan to restructure $8.8 billion in short-term debt, which included government guarantees for the debt of less creditworthy state corporations and the acceptance of tougher borrowing terms. Nonetheless, Caracas was able to refinance only $1.5 billion in short-term debt, half the amount targeted for restructuring in 1982. To cover the shortfall, it drew down reserves by $2 billion. [redacted] 25X1

Reserves also were being drained by soaring capital flight, [redacted] triggered by declining private-sector confidence in Herrera's economic policies. These outflows accelerated as the year wore on due to persistent devaluation rumors in the wake of other Latin American repayment problems. In September, Caracas vainly attempted to bolster confidence in the bolivar by consolidating the reserves of the oil company under Central Bank control and by revaluing its gold holdings. Other moves to stem dollar drain included tightening monetary policy and introducing new import restrictions and prohibitions in November. Despite these efforts, capital flight had depleted $5 billion in reserves by the end of the year, according to Venezuelan Central Bank estimates. [redacted] 25X1

Near-Term Outlook

Economic Policy Choices in an Election Year. President Herrera's dilemma during his last full year in office will be to reconcile economic austerity with party demands to rescue candidates through visible public spending. Flat oil earnings and tight international credit markets will prevent large-scale, politically motivated spending. Thus, with the administration widely discredited—and the ruling COPEI candidate, Rafael Caldera, trailing far behind opposition AD candidate Jaime Lusinchi in all of the polls—a COPEI defeat next December seems likely. [redacted] 25X1 25X1

Herrera, who attaches considerable importance to how his administration will be judged after he leaves office, will probably act to preserve his record in reducing inflation, restoring fiscal balance, and maintaining a stable bolivar and healthy reserves. His public statements indicate a recognition that to retreat from austerity would nullify any gains achieved and could lead to a full-blown financial crisis. According to informed press sources, the President has warned ruling party leaders that the opposition would be quick to criticize more spending as an attempt to buy votes and that the electorate is already aware that resources are lacking. In addition, Herrera harbors great personal dislike for COPEI candidate Caldera. 25X1 Thus, the President may compromise on some individual spending items, but we expect him to preserve the integrity of most of his programs. [redacted] 25X1

The conservative 1983 budget that Herrera submitted to Congress late last year conveyed this image of fiscal responsibility. 25X1 Total revenues and expenditure projections are balanced at $18.1 billion, based on petroleum tax revenues of only $11.1 billion, down from $16.5 billion in 1981. These projected expenditures represent a decline of 10 percent over estimated

COPEI presidential candidate Rafael Caldera *The Daily Journal*

AD presidential candidate Jaime Lusinchi *Bohemia*

1982 spending. For the second year in a row, nonoil investment programs will bear the brunt of programed cutbacks. [redacted]

We expect that revenue shortfalls will soon force Caracas to consider even tougher budget cuts. In projecting oil tax revenues, government planners assumed average exports of 1.6 million barrels per day at $27.42 per barrel, which closely matched export and price levels earlier this year. Recently, however, the OPEC benchmark price was lowered by $5 per barrel. Moreover, a new OPEC production-sharing agreement will probably limit Venezuelan oil exports to just over 1.4 mb/d. Consequently, petroleum earnings are likely to fall to $13.3 billion, causing fiscal oil revenues to drop by $3 billion to only $8.7 billion. An uncontrolled decline in oil prices, however, would devastate the Venezuelan economy. For each $1 per barrel reduction in oil prices, Venezuelan annual petroleum revenues will fall approximately $500-600 million, reducing projected budget revenues by some 3 percent. (See the appendix for a full explanation of the methodology employed in our projections.) [redacted]

In this crucial election year, there will be negative consequences no matter what Herrera decides to do. Holding the line on spending would alienate labor, boost unemployment, and cause a sharp decline of incomes, all of which will hurt the Social Christian Party's chances at the polls. These effects could be moderated somewhat by freer spending, but other serious economic repercussions would occur: higher inflation and the possible reimposition of price controls, weakened business and lender confidence, and decreased private-sector investment and expansion. [redacted]

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Looming Financial Complications. We anticipate that further unappealing adjustments will be forced on Herrera this year by external difficulties. Reserve levels are inadequate to finance a second consecutive current account deficit and banker demands for payments of maturing debt. Despite continued widespread speculation, Herrera has adamantly opposed attacking the reserve drain with a major devaluation for fear it would sharply increase prices and prove a major political embarrassment. [redacted]

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For similar reasons he resisted the imposition of exchange controls until forced on him by the disarray in oil markets, a logjam in refinancing efforts, and soaring speculative capital movements. In late February, the government suspended foreign exchange

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Table 2
Venezuela's Oil Earnings

Billion US $
(except where noted)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982 [a]	1983 [a]
Oil export revenues	4.38	10.5	8.4	8.7	9.2	8.7	13.7	18.3	19.1	15.2	13.3
Average production *(million barrels/day)*	3.37	2.98	2.35	2.29	2.24	2.17	2.36	2.16	2.10	1.90	1.80
Average exports *(million barrels/day)*	3.15	2.75	2.09	2.14	1.96	1.96	2.12	1.86	1.76	1.55	1.40
Average price per barrel of crude export (*US $*)	3.71	10.53	10.99	11.25	12.61	12.20	17.70	26.40	29.70	27.50	26.00
Fiscal petroleum revenues	2.6	8.6	7.5	6.6	6.8	5.9	7.7	10.6	16.5	11.7	8.7

[a] Estimated.

[redacted] 25X1

transactions for one week, implemented exchange controls, and introduced a three-tiered multiple exchange rate system, the first in 18 years. At the same time, prices on all goods and services were frozen for 60 days to prevent sharp price increases. [redacted]

We estimate a better-than-even chance, however, that Caracas will still encounter a foreign exchange crisis by the end of the year. We doubt that the government will halt foreign exchange outflows with the measures now in force. Election year uncertainty has heightened expectations of a major devaluation, providing strong incentives for subverting the system through black-market operations. Meanwhile, powerful interest groups have been effectively lobbying the administration for access to the preferential exchange rates, potentially undermining the effectiveness of the system. We also anticipate that import restrictions will prove inadequate to reduce the deficit on current account. Hence, we believe that Caracas will have little alternative but to devalue later in the year to prevent the exhaustion of liquid reserves. They were already less than $3 billion by the end of February, according to US Embassy reporting. [redacted]

[redacted] international lenders have suspended refinancings of maturing debt because of growing arrearages on debt repayments and the prospect of a precipitous drop in Venezuela's oil earnings. [redacted] 25X1

[redacted] 25X1

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Should bankers refuse Sosa's rescheduling requests, we believe Caracas would soon have little choice but to suspend debt repayments and begin formal debt rescheduling negotiations with international banks and, perhaps, the International Monetary Fund. In either case, lenders would almost certainly condition their cooperation on a devaluation of the bolivar and deeper austerity moves, including real program cuts and the withdrawal of consumer price subsidies. [redacted] 25X1

Such a financial crisis would ensure the defeat of Rafael Caldera in the December election. The stricter austerity measures would probably lead to increased demonstrations and strikes by the national labor confederation, whose members are for the most part allied with the opposition Democratic Action party. With the presidency and control of the national Congress at stake in December, however, we believe that labor will be kept under control by expectations that it would shortly be given a significant role in fashioning the new administration's economic policies. [redacted]

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This view notwithstanding, reliable US Embassy sources report increasing military concern over the grim near-term outlook and the Herrera administration's inability to cope with it. The bulk of the reporting does not indicate that the military is considering withdrawing its support from the government at this time [redacted] a more drastic downturn in the economy than we envision, accompanied by food shortages and urban unrest, could cause some elements within the armed forces to reassess this commitment. [redacted]

Longer Term Prospects

Economic Stresses and Accommodations. The failure to promote economic diversification will leave Venezuela's economic performance throughout the 1980s at the mercy of trends in world oil markets. Despite large public investments, Venezuela's nonoil economy has stagnated during the past four years, as measured by real growth in mining, manufacturing, and agriculture. As a result, oil production and exports will continue to drive the economy. Largely on the basis of assumptions of only moderate growth in the world economy through the mid-1980s, many independent energy experts do not foresee any significant upturn in world demand for oil to strengthen crude prices for the next four to six years. In addition, finances will be constrained by the need to service the large debt. The combined effect, we believe, will be lackluster economic growth rates—no better than 2 percent—over the next five years. [redacted]

We believe, in part on the basis of opinion polls, that this deterioration is producing a consensus among Venezuelans regarding the dangers of uncontrolled spending and overheated economies, particularly since Mexico's financial debacle. This and the ideological similarities of the two major parties mean that both major presidential candidates will be likely to pursue similar austere economic strategies until export recovery or foreign borrowing permits a more aggressive tack. The goals will be to reassure foreign lenders of Venezuela's abilities to manage its finances and to convince the electorate that belt-tightening measures are unavoidable. [redacted]

We foresee several specific budget-balancing tactics to meet these goals. To offset the drop in oil revenues—normally some 70 percent of total budgetary revenues—we expect increased taxation of nonoil revenues, greater efforts to promote government efficiency, selected cuts in both investment projects and social services, and reduced subsidies for some consumer products. Cutbacks will also fall on the unprofitable and sometimes corrupt state enterprises. In a resource-scarce future, public tolerance of the budget- 25X1
draining effects of this corruption and inefficiency will, we believe, wear thin. Nevertheless, these enterprises account for over 60 percent of all public expenditures and, with the rest of the federal govern- 25X1
ment, employ some 23 percent of the country's total work force. Thus, gains will be achieved only slowly, as political leaders warn that the social backlash of widespread firings would outweigh any resultant improvements in efficiency. [redacted] 25X1

In our judgment, Venezuela's weakened finances will make its policymakers increasingly aware of the need to undertake more fundamental economic reforms. As the decline in public expenditures threatens to sharply reduce growth and employment, government leaders are more frequently citing the need to spur private-sector performance. We expect to see new initiatives to permit market forces freer rein while easing frictions between government and business. This changing attitude is also leading to greater interest in attracting more foreign investment, which could eventually help correct the country's existing shortages of capital, technology, and skilled management and labor. [redacted] 25X1

We believe that austerity and reforms will also be in order for the oil industry. Depressed profits and declining reserves already have caused PDVSA to scale back by roughly one-third the $37 billion initially planned for investment between 1983 and 1988 and to reconsider its overall development strategies. Oil ministry officials now say they will concentrate on increasing production of light and medium crudes from traditional fields rather than accelerate production from the more costly Orinoco Heavy Oil Belt. While the primary motivation behind this shift is the questionable future profitability of heavy oil production, PDVSA increasingly will find its development 25X1

plans influenced by new financial constraints. In particular, the larger scale investments necessary even to maintain productive capacity will require external financing as well as unrestricted access to PDVSA reserves held by the Central Bank. [redacted]

Political Implications. Venezuela's economic difficulties over the next several years will place unaccustomed stress on the political system, in our view. The sectors of society that have benefited most from the oil-driven prosperity—the middle class, organized labor, the military, businessmen—are also Venezuela's most politically powerful groups. The demands that each could press upon the government are likely at times to conflict with those of other groups as well as with what the government will see as the national interest. [redacted]

These sectors are mostly urban centered, reflecting the rapid transition from a rural society just 30 years ago to one where three out of four Venezuelans live in cities. The two dominant political parties have been slow to adjust to this trend, according to published studies. Partly for this reason and partly as a natural function of rapid urbanization, many of the migrants have lost their party ties—though not necessarily their support for the system. Some 60 percent of Venezuelans—primarily these urban migrants—identify themselves as independents. Thus, we believe the dilemma facing the two parties is that, at a time when resources are less plentiful, the expansion of their bases depends in part on their ability to increase benefits to a highly mercurial group of voters. [redacted]

Making other necessary adjustments will be difficult. In Venezuela's favor, we give considerable weight to its strong and well-rooted democratic political institutions, a rare deviation from the personalism and cyclical military intervention that predominate in Latin America. These institutions have contributed to a national politics of consensus that still dominates public attitudes. The most recent opinion polls indicate that, whatever the shortcomings of the system over the past 25 years, Venezuelans still overwhelmingly prefer it to the alternatives represented by either domestic radical groups or foreign systems. This is particularly true of the middle class and elites, whose participation historically has been more essential than that of the masses in any effort to overturn the government. [redacted] 25X1

Given these attitudes, the most credible threat to the democratic structure has been and remains intervention by the conservative military. [redacted] military support for constitutional processes and our view of the probable extent of economic problems over the next few years, we judge the chances of a military takeover to be slight. Instead, we believe that continuing hard times will reinforce the tendency of voters to alternate the parties in power. [redacted] 25X1 25X1 25X1 25X1

Sources and Signs of More Serious Trouble. Our assessment of political prospects would change under a much more adverse economic scenario. In the unlikely event that Venezuela's oil earnings fell drastically—such as would occur if an all-out price war among producing nations dropped the average OPEC per barrel price to $20—draconian and politically difficult adjustment measures would be called for. Reluctance by the government to take such steps would quickly seal off access to external financing. [redacted] 25X1 25X1

Forced to survive solely on greatly diminished oil revenues, Venezuela would have to curtail imports severely. Over a period of some months, this would cause unmanageable industrial bottlenecks and shortages of consumer goods and food, over half of which is imported. In addition, inflation would soar, private and public investments would dry up, and public services would deteriorate rapidly. [redacted] 25X1 25X1

During the buildup period of this scenario, we would anticipate certain indicators of impending political instability:

- Serious questioning of the efficacy of the political system by the responsible press or by the public in opinion polls.
- Dramatic differences between the two major parties over fundamental economic and political policies.

- Open fighting within either major party over policies or leadership, or inability of either party to accommodate large personalist or ideological splinter groups.
- A significant increase in the percentage of votes for third party candidates of the left or right, particularly in urban areas.
- New alignments among disaffected interest groups, such as labor supporting students.
- Larger turnouts for demonstrations called by extremist political parties.
- Use of the armed forces to curb civil disorders.
- Increased military concern over economic and security issues and government catering to military opinion on these questions. [redacted]

An economic crisis of the proportions we posit probably would produce drastic political change not through a spontaneous civil uprising, but through preemptive action by a well-organized sector. Labor would be among the first to take to the streets, but most unions—according to US Embassy reporting—are closely affiliated with one of the two major parties. While this might not prevent labor from stirring up large-scale disorders, it would make it difficult for unions to cooperate in exploiting the situation. Students likewise would contribute to civil disturbances, in our view, but would have little chance of politically capitalizing on them. Radical leftist groups—both parties and violence-prone groups—would make a serious effort to take advantage of conditions. We judge that their capabilities to do so any time soon are limited. Guerrilla groups have all but disappeared from the country, according to US [redacted] and would take time to rebuild. [redacted] nonviolent radical organizations continue to be divided, weak, and inept, and the economic problems we envision would probably not infuse them with sufficient strength to threaten the system. [redacted]

We believe that among all major interest groups the military would be the most capable of seizing power and the most likely to do so. The armed forces would act out of disgust with the civilian government, anger over severe cutbacks in defense spending, and fear of the left. The military probably would find considerable support for its action among businessmen and conservative politicians, who would see such an alliance as more profitable than acting on their own. [redacted] 25X1

Implications for the United States

Venezuela remains a strong supporter of democracy in Latin America, the sixth-largest exporter of petroleum to the United States, and the second-largest Latin American importer of US goods. These ties—combined with Venezuela's role as an Andean, Amazonian, and Caribbean power—have given Caracas a unique standing in regional affairs that has generally buttressed US policy [redacted] 25X1

Venezuelan officials are seeking US help in coping with their financial dilemma. [redacted] These included the opening of a standby emergency line of credit, new credit for Venezuela's wheat imports, prepayment for future petroleum deliveries, and a gold-swap arrangement. The Venezuelans are especially seeking the help of senior US financial officials in enlisting the cooperation of US banks in refinancing and restructuring existing obligations. [redacted] 25X1 25X1 25X1 25X1

The deteriorating financial situation is already contributing to a rise in protectionism that, according to the US Embassy, could harm some US exports to Venezuela. On the other hand, recent official statements indicate that Caracas is becoming increasingly receptive to foreign equity participation in development projects, particularly in the petroleum field. We believe that this in turn could permit favorable resolution of some of the tax claims levied on US oil companies after nationalization in 1976. [redacted] 25X1 25X1 25X1

Venezuelan leaders will look to the United States for moral support as well as concrete assistance. They will probably cite security, common ideology, and trade to justify greater US backing. They will also argue that failure to receive such support will work to the advantage of nationalistic, leftist elements in Venezuela and compel policy shifts unfavorable to US interests. [redacted] 25X1 25X1

In our view, Venezuela will continue to promote democracy in Central America and the Caribbean, but its ability to influence developments will be circumscribed by a preoccupation with domestic economic and political problems. Moreover, presuming Democratic Action candidate Lusinchi wins, his lack of experience in foreign affairs and preoccupation with domestic matters could leave the field to former President Carlos Andres Perez, whose views on Caribbean Basin issues often have been at odds with those of the United States. Although Lusinchi and other party leaders do not agree with Perez's views on Central America, they are unwilling to rein him in for fear of jeopardizing party unity. Perez's influence thus could lead to reduced Venezuelan support both for Nicaragua's opposition forces and El Salvador's Government. 25X1

Declining resources may also jeopardize the joint Venezuelan-Mexican oil financing facility. Since 1974, $6.5 billion has been disbursed in various forms of economic assistance to the Caribbean Basin. Although $400 million was paid out in 1982, Venezuela has recently been discouraging expectations that it will increase aid or soften credit terms. According to a US Embassy source, Energy Minister Calderon Berti has said that prospects are not encouraging for renewing the facility for another year in August. He implied that if Mexico withdraws and the agreement lapses, Venezuela probably will continue providing some reduced level of aid and look to the United States to step up its assistance. 25X1

Other foreign policy implications will involve Venezuelan participation in multilateral forums and issues. Mindful of the role that US firms and lending institutions can play in its economic recovery, Venezuela may reconsider its frequent posturing as a self-appointed spokesman for the Third World on North-South issues. We also believe that Venezuela may become less inclined than previously to press its boundary disputes with Guyana and Colombia. The military—already doubtful of its capability if called upon to enforce Venezuela's claims—would be reluctant to act, especially when budget cuts will mean an even greater strain on resources. 25X1

Appendix

Methodological Notes on Economic Forecasts

In assembling the various economic and petroleum data for this assessment, we relied primarily on Venezuelan statistics, US Embassy reporting, and independent publications. To supplement official economic data, we relied on the International Monetary Fund's annual consultations for the most current and consistent data series. [redacted]

Petroleum Developments
Given the overwhelming influence of oil on Venezuela's economic fortunes, we first addressed petroleum's earning potential for 1983. In estimating oil revenues, our key assumptions are as follows:

- Even with modest economic growth of 2 percent in the developed nations, we estimate demand for OPEC oil will average only about 20 million barrels per day (mb/d) for the year, or about the same as last year.[1]

- We assume that average oil export prices will erode further for OPEC members as the pricing structure is reordered around a $29 benchmark.

- On balance, we believe that OPEC will succeed in preventing an uncontrolled price decline by adopting production-sharing agreements. (C NF)

Accordingly, our base case scenario for Venezuelan oil exports in 1983 incorporates both a cut of $5 per barrel in the OPEC benchmark price and an agreement to limit production for at least one quarter in 1983:

- We have incorporated an OPEC limit on Venezuelan production of 1.7 mb/d. Assuming domestic consumption of 400,000 b/d—which is consistent with both government and independent forecasts—and some drawdown of existing stocks for export, this would allow for yearend exports of approximately 1.4 mb/d. 25X1

- Due to budget constraints, we believe it highly unlikely that Venezuela would accept a production limit below this minimum 1.7 level. Rather than risk a potentially disastrous price war, we believe Caracas will accede to the imposition of production limits. 25X1

- We estimate that the reduction of $5 in the OPEC benchmark price would cause only a $2 decline per barrel for Venezuela's oil exports. Seventy percent of Venezuela's oil exports are products or heavy crudes whose prices are not directly tied to the OPEC pricing structure.

- With exports averaging approximately 1.4 mb/d at an average export price per barrel of $25.50 for the last three quarters of 1983, oil revenues would total $13.3 billion. This estimate is very sensitive to changes in OPEC strategies. We estimate that annual revenues would fall by $500-600 million for every $1 per barrel reduction in Venezuela's export price. For each annual production decline of 200,000 b/d, at constant prices, Venezuela's revenues would decline by approximately $1.6 billion.

- Fiscal revenue predictions are based on estimated PDVSA operating costs of $3.3 billion—incorporated into both industry and GOV revenue projections—and a legal claim to 10 percent of pretax earnings. With revenues of $13.3 billion, the oil industry would retain a minimum of $1.33 billion, leaving a net of $8.7 billion for the government.

[redacted]

25X1

- Our worst case scenario has benchmark OPEC oil prices falling to an average $20 per barrel for at least a year—and Venezuela's average earnings per barrel to $16.22—as an all-out price war erupts. Assuming that such a drop increases demand for OPEC oil, Venezuela could export 1.975 mb/d, yielding annual petroleum revenues of $11.7 billion, and fiscal revenues of $7.23 billion. [redacted] 25X1

Current Account

We believe Venezuela's current account deficit this year will be essentially unchanged from last year's estimated $2.2 billion deficit:

- Despite a 3-percent increase in import costs, Venezuelan imports will likely drop to $11.4 billion, down 15 percent from last year. Higher import tariffs and restrictions introduced last November and tighter access to trade credit will keep imports flat during the first half of the year. We then anticipate a significant drop in imports as exchange controls and devaluation begin to bite.

- The services deficit will increase slightly because of rising interest costs on foreign debt. [redacted] 25X1

Caracas will likely look to international bankers to finance part of this deficit in order to limit the drain on declining foreign exchange reserves. Should reserves drop to minimal levels and both trade credits and new loans not be forthcoming, we would expect Caracas to cut back much further in imports and approach the IMF for financial assistance. [redacted] 25X1